TREASURY | PARTNERS

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Have Patience

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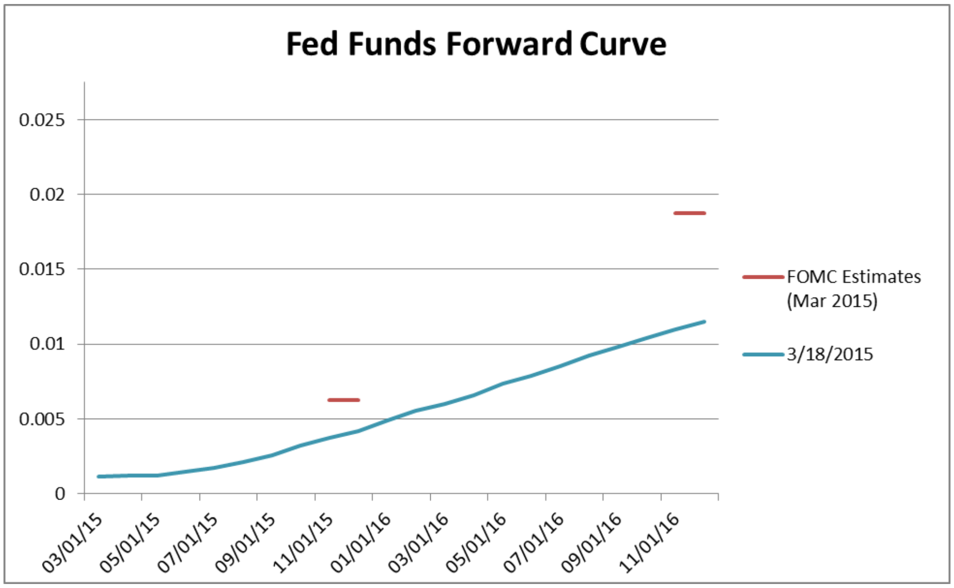
Overview

For 6 ½ years, the Federal Reserve has been undertaking various measures to repair the damage caused by the 2008 Financial Crisis. Overnight rates have been held at zero. Multiple quantitative easing (QE) programs were undertaken to suppress the long end of the yield curve by buying outstanding Treasury and Mortgage-Backed bonds. The Fed's balance sheet expanded to $4.5 trillion. Starting last year, QE purchases were tapered, and the buying program ended completely in late 2014. Now, the Fed is turning to the task of adjusting its communications to prepare the markets for an eventual Fed Funds rate increase. *For short term corporate cash investors, this is a critical period to understand market developments.*

Analysis and Portfolio Impacts

- After the Fed's March 18th statement, we now have a very data dependent Fed. And, for the first time since 2003, there is no "forward guidance" about rates. Starting in June, each FOMC meeting should be considered a "live meeting", where the Fed may raise rates. Chairman Yellen has emphasized this includes meetings with no previously-scheduled press conference: the Fed is prepared to call a conference if necessary. *For that reason, it is important that all portfolios either retain some dry powder or natural maturities through a properly laddered investment structure.*
- Some recent economic and inflation data have been soft. This could be related to the West Coast port strike and the particularly severe winter. If the data does not deteriorate further, or if it rebounds, we expect a 25 basis point rate hike sometime in the June-September '15 time period. This will be the first rate hike since 2006. Many market participants active today have never seen the impact of a Fed hike on the bond market. *Depending on market expectations, the hikes will drive rates higher on 2 and 3 year maturities.*

  Oil prices have fallen by more than 50% since their peak last summer. At the same time, the US dollar has strengthened significantly against most major global currencies. Neither of these are technically factors the Fed seeks to influence. However, we can't rule out the potential that continued energy weakness and/or dollar strength may impact the Fed's thinking, causing them to be more cautious in raising rates.
- A discrepancy exists between the Fed Governors' rate expectations and where the markets believe the fed funds rate will be at year-end 2015 and 2016. As the chart below illustrates, there is a 25 basis point (0.625% vs 0.38%) disparity at year-end 2015 and 75 basis point (1.88% vs 1.13%) at year-end 2016. What is more striking is that the Governors lowered their rate expectations significantly from just three months ago (see Client Alert dated 2/17/2015). For example, the target rate for Fed Funds dropped from 1.125% to 0.625% and 2.5% to 1.875%, respectively for year-end 2015 and 2016. Our interpretation of this very significant change is that subsequent rate hikes are expected to be moderate. *This implies the risk of extending maturities is lower and presents an opportunity to assume duration risk in an upward sloping rate environment.*



Source: Bloomberg, Federal Reserve Board

Strategy

As the Fed approaches “liftoff”, short term rates will be volatile. Following Wednesday’s Fed meeting, market participants seized on the downward revision to the Fed meeting participants’ rate expectations and projection for “full” employment to drive the short end of the yield curve down sharply (see chart). But let’s not miss the upward trend that is in place: the saw-toothed pattern of higher highs and higher lows in two and three year rates is intact.

As the Fed slowly normalizes policy, patience will be critical. Our overall strategy is to maintain shorter skewed laddered portfolios, adding positions during rate peaks, and avoiding troughs. After six years of avoiding floating rate bonds, we will now start to consider these instruments.

For clients with large cash balances, we will maintain a methodically slow, opportunistic deployment of funds. For clients with fully invested portfolios, we may allow a partial buildup of cash positions to opportunistically capture rate peaks.

As always, please contact us at any time if you would like to discuss our strategy in greater detail.

Two Year Treasuries

Source: Bloomberg

Three Year Treasuries

Source: Bloomberg

Disclosure

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